

Tennessee State School Bond Authority

**For the Year Ended
June 30, 1997**

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February 26, 1998

The Honorable Don Sundquist, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable W. R. Snodgrass
Comptroller of the Treasury
Secretary of the Tennessee State School Bond Authority
State Capital
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee State School Bond Authority for the year ended June 30, 1997. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance disclosed certain deficiencies, which are detailed in the Results of the Audit section of this report. The authority's management has responded to the audit finding; the response is included following the finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit finding.

Very truly yours,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Tennessee State School Bond Authority
For the Year Ended June 30, 1997

AUDIT OBJECTIVES

The objectives of the audit were to consider the authority's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, and contracts; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDING

Accounting Procedures Are Needed

The authority does not have practical guidelines and procedures to ensure transactions are properly recorded (page 7).

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-0264
(615) 741-3697

Audit Report
Tennessee State School Bond Authority
For the Year Ended June 30, 1997

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Tennessee State School Bond Authority For the Year Ended June 30, 1997

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Tennessee State School Bond Authority. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

LEGISLATIVE HISTORY

The Tennessee State School Bond Authority was established by the Tennessee State School Bond Authority Act, Chapter 256 of the Public Acts of 1965. As provided in this act, the authority is to act as a corporate governmental agency of the State of Tennessee for financing projects of the state’s higher education institutions. The authority is empowered to issue negotiable bonds and notes as a means of providing funds for financing approved projects. These projects include buildings, equipment, structures, and improvements. In 1980, the legislature amended the original act to include, as a project, a program for student loans. The amount of funds provided should be sufficient to cover the actual project costs, as well as the authority’s administrative expenses, including the cost of conducting the bond and note sales.

ORGANIZATION

The Tennessee State School Bond Authority consists of seven members: the Governor, the State Treasurer, the Secretary of State, the Commissioner of Finance and Administration, the Comptroller of the Treasury, the Chancellor of the Tennessee Board of Regents, and the President of the University of Tennessee. The Governor serves as chairman, and the Comptroller of the Treasury serves as secretary. The Director of the Division of Bond Finance serves as the assistant secretary; the division provides administrative and financial services to the Tennessee State School Bond Authority.

An organization chart for the authority is on the following page.

AUDIT SCOPE

The audit was limited to the period July 1, 1996, through June 30, 1997, and was conducted in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Financial statements are presented for the year ended June 30, 1997, and for comparative purposes, the year ended June 30, 1996. The Tennessee State School Bond Authority has been included as a component unit in the *Tennessee Comprehensive Annual Financial Report*.

The audit covered allotment code 307.07—Division of Bond Finance (Fund 32).

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the authority's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, and contracts;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

Although this audit was not intended to serve as an organization-wide audit as described in the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and Office of Management and Budget (OMB) Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," it included tests of compliance with applicable federal laws and regulations and consideration of internal control. This audit is a segment of the organization-wide audit of the State of Tennessee, which is conducted in accordance with the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and OMB Circular A-133.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the Tennessee State School Bond Authority's financial statements for the year ended June 30, 1997, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. A reportable condition, along with the recommendation and management's response, is detailed in the finding and recommendation. Consideration of internal control disclosed no material weaknesses.

Compliance

The results of our audit tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the financial statements of the Tennessee State School Bond Authority.

**Report on Compliance and on Internal Control Over Financial Reporting
Based on an Audit of the Financial Statements
Performed in Accordance With *Government Auditing Standards***

December 16, 1997

The Honorable W. R. Snodgrass
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Snodgrass:

We have audited the financial statements of the Tennessee State School Bond Authority, a component unit of the State of Tennessee, as of and for the year ended June 30, 1997, and have issued our report thereon dated December 16, 1997. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the authority's financial statements are free of material misstatement, we performed tests of the authority's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the authority's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing

The Honorable W. R. Snodgrass
December 16, 1997
Page Two

our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the authority's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

The following reportable condition was noted:

- Accounting procedures are needed.

This condition is described in the Finding and Recommendation section of this report.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness.

We also noted other matters involving the internal control over financial reporting that we have reported to the authority's management in a separate letter.

This report is intended for the information of the General Assembly of the State of Tennessee and management. However, this report is a matter of public record, and its distribution is not limited.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/th

FINDING AND RECOMMENDATION

Accounting procedures are needed

Finding

The authority does not have practical guidelines and procedures to ensure transactions are properly recorded. Specific written guidance would seem critical, considering the complexity and number of transactions. The following problems indicate the need for such guidance.

- Entries for the four November 1996 bond issues, the November 1996 semiannual billing to the higher education institutions, and the May 1997 semiannual billing were not completed and posted to the accounting records until November 1997. Also, many adjusting entries to the general ledger were required during audit field work, delaying the closing of the books until December 4, 1997.
- Not all activity related to cash and investments held by the trustee was recorded in the accounting records during the fiscal year. Adjustments totaling \$475,751 were made to these accounts in the general ledger during audit field work. Also, interest earnings totaling \$264,590 on the escrow account held by the trustee were not reflected in the accounting records until December 1997.
- The Statement of Cash Flows amounts for “purchases of investments” and “proceeds from sales and maturities of investments” were not obtained from the bank statements. Instead, the amounts were partially determined by comparing the June 30, 1996, and June 30, 1997, cash and investment amounts, contributing to a \$124,594 unexplained variance on the Statement of Cash Flows.
- Numerous transactions in the general ledger were misclassified. In addition, errors were discovered in some of the year-end entries, including the entries to record accrued interest payable and interest due from higher education institutions. Also, the terminology used in the descriptions of transactions was sometimes unclear or inconsistent, and explanations for some transactions were not documented.

Management is responsible for establishing the policies and procedures necessary to ensure transactions are properly recorded. The appropriate adjusting entries were made to correct the accounting records.

Recommendation

Management should establish adequate written policies and procedures to provide personnel with proper guidance for the accurate and timely recording of accounting transactions.

Management should take steps to ensure that appropriate personnel comply with these policies and procedures on a timely basis.

Management's Comment

We concur that the authority did not have guidelines and procedures to ensure that transactions were properly and timely recorded. Management is taking steps to document procedures for recording transactions and provide training to staff in the implementation of new Governmental Accounting Standards Board Statements related to accounting for debt.

Independent Auditor's Report

December 16, 1997

The Honorable W. R. Snodgrass
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Snodgrass:

We have audited the accompanying balance sheets of the Tennessee State School Bond Authority, a component unit of the State of Tennessee, as of June 30, 1997, and June 30, 1996, and the related statements of revenues, expenses, and changes in retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the authority's management. Our responsibility is to express an opinion on these financial statements, based on our audits.

We conducted our audits in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tennessee State School Bond Authority, as of June 30, 1997, and June 30, 1996, and the results of its operations and cash flows for the years then ended in conformity with generally accepted accounting principles.

The Honorable W. R. Snodgrass
December 16, 1997
Page Two

As discussed in Note 6 to the financial statements, the 1996 financial statements have been restated to reflect the accretion to date of interest on capital appreciation bonds.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 16, 1997, on our consideration of the authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, and contracts.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/th

TENNESSEE STATE SCHOOL BOND AUTHORITY
BALANCE SHEETS
JUNE 30, 1997, AND JUNE 30, 1996

(Expressed in Thousands)

	<u>June 30, 1997</u>	<u>June 30, 1996</u>
<u>ASSETS</u>		
Current assets:		
Cash (Note 2)	\$ 11,348	\$ 14,568
Cash with fiscal agent (Note 2)	1,232	1,685
Investments with fiscal agent (Note 2)	227	-
Principal due from higher education institutions (Note 3)	20,187	15,051
Interest due from higher education institutions (Note 3)	1,365	586
Other receivable from higher education institutions	<u>296</u>	<u>216</u>
Total current assets	<u>34,655</u>	<u>32,106</u>
Restricted assets (Notes 2 and 4):		
Advance refunding investments	8,416	-
Debt service reserve	<u>39,331</u>	<u>30,528</u>
Total restricted assets	<u>47,747</u>	<u>30,528</u>
Other assets:		
Advances to higher education institutions - principal (Note 3)	307,720	297,020
Deferred charges	<u>1,183</u>	<u>995</u>
Total other assets	<u>308,903</u>	<u>298,015</u>
Total assets	<u><u>\$ 391,305</u></u>	<u><u>\$ 360,649</u></u>
<u>LIABILITIES AND EQUITY</u>		
Liabilities:		
Current liabilities:		
Accounts payable	\$ 21	\$ -
Warrants payable	-	40
Due to higher education institutions	2,581	1,197
Matured bonds and interest payable	824	768
Accrued interest payable	3,081	2,654
Notes payable (Note 5)	42,095	104,585
Revenue bonds payable (Note 5)	20,187	15,051
Deferred revenue	<u>48</u>	<u>38</u>
Total current liabilities	<u>68,837</u>	<u>124,333</u>
Noncurrent liabilities:		
Net revenue bonds payable (Note 5)	<u>317,046</u>	<u>231,590</u>
Total liabilities	<u>385,883</u>	<u>355,923</u>
Equity:		
Retained earnings, unreserved	<u>5,422</u>	<u>4,726</u>
Total liabilities and equity	<u><u>\$ 391,305</u></u>	<u><u>\$ 360,649</u></u>

The notes to the financial statements are an integral part of this statement.

TENNESSEE STATE SCHOOL BOND AUTHORITY
STATEMENTS OF REVENUES, EXPENSES,
AND CHANGES IN RETAINED EARNINGS
FOR THE YEARS ENDED JUNE 30, 1997, AND JUNE 30, 1996

(Expressed in Thousands)

	Year Ended <u>June 30, 1997</u>	Year Ended <u>June 30, 1996</u>
<u>OPERATING REVENUES</u>		
Revenue from higher education institutions	\$ 18,574	\$ 15,455
Investment income	<u>3,464</u>	<u>2,751</u>
Total operating revenues	<u>22,038</u>	<u>18,206</u>
<u>OPERATING EXPENSES</u>		
Interest expense:		
Revenue notes	2,003	2,298
Revenue bonds	<u>18,841</u>	<u>15,851</u>
Total interest expense	<u>20,844</u>	<u>18,149</u>
Administrative expense	<u>319</u>	<u>412</u>
Amortization of bond issuance costs	<u>179</u>	<u>65</u>
Total operating expenses	<u>21,342</u>	<u>18,626</u>
Operating income (loss) before operating transfer	696	(420)
Operating transfer from primary government	<u>-</u>	<u>34</u>
Net income (loss)	696	(386)
Retained earnings, July 1	<u>4,726</u>	<u>5,112</u>
Retained earnings, June 30	\$ <u><u>5,422</u></u>	\$ <u><u>4,726</u></u>

The notes to the financial statements are an integral part of this statement.

TENNESSEE STATE SCHOOL BOND AUTHORITY
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 1997, AND JUNE 30, 1996

(Expressed in Thousands)

	Year Ended June 30, 1997	Year Ended June 30, 1996
Cash flows from operating activities:		
Operating income (loss)	\$ 696	\$ (420)
Adjustments to reconcile operating income to net cash used by operating activities:		
Amortization	179	65
Investment income	(3,464)	(2,751)
Interest expense	20,844	18,149
Interest income	(18,396)	(15,123)
Changes in assets and liabilities:		
Increase in other receivable from universities	(80)	(216)
Increase (decrease) in accounts payable	21	(8)
Increase (decrease) in warrants payable	(40)	40
Increase in matured bonds and interest payable	56	52
Increase in deferred revenue	10	38
Total adjustments	(870)	246
Net cash used by operating activities	(174)	(174)
Cash flows from noncapital financing activities:		
Proceeds from sale of bond anticipation notes	14,350	53,775
Proceeds from sale of bonds	166,378	-
Cost of issuance paid	(248)	-
Call premium paid	(843)	-
Principal payments - bonds	(75,412)	(14,838)
Principal payments - notes	(76,840)	(2,240)
Interest paid - bonds	(18,360)	(14,100)
Interest paid - notes	(2,065)	(2,247)
Operating transfer from primary government	-	34
Net cash provided by noncapital financing activities	6,960	20,384
Cash flows from investing activities:		
Purchases of investments	(47,769)	(7,151)
Proceeds from sale and maturities of investments	14,522	21,924
Interest received on investments	3,464	2,751
Loans issued	(40,225)	(52,350)
Collections of loan principal	25,739	16,914
Interest received on loans	17,834	13,139
Net cash used by investing activities	(26,435)	(4,773)
Net increase (decrease) in cash	(19,649)	15,437
Cash, July 1	32,229	16,792
Cash, June 30	\$ 12,580	\$ 32,229
Reconciliation of cash to the balance sheet:		
Cash	\$ 11,348	\$ 14,568
Cash with fiscal agent	1,232	1,685
Restricted cash with fiscal agent	-	15,976
Cash, June 30	\$ 12,580	\$ 32,229
Noncash investing, capital, and financing activities:		
Accretion of capital appreciation bonds	\$ 1,773	\$ 1,866
Bond issuance costs	654	-
Total noncash investing, capital, and financing activities	\$ 2,427	\$ 1,866

The notes to the financial statements are an integral part of this statement.

Tennessee State School Bond Authority
Notes to the Financial Statements
June 30, 1997, and June 30, 1996

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The Tennessee State School Bond Authority was created to provide a mechanism for financing capital projects for the state's higher education institutions. The authority is a component unit of the State of Tennessee and a separate legal entity. In accordance with the Governmental Accounting Standards Board's (GASB) Statement 14, the authority is discretely presented in the *Tennessee Comprehensive Annual Financial Report* because the authority's board consists of state officials and, therefore, the state has the ability to affect the day-to-day operations of the authority.

Basis of Presentation

The accompanying financial statements have been prepared in conformity with generally accepted accounting principles as prescribed by the GASB. The Tennessee State School Bond Authority follows all applicable GASB pronouncements as well as applicable private sector pronouncements issued on or before November 30, 1989.

Measurement Focus and Basis of Accounting

The accompanying financial statements have been prepared using the accrual basis of accounting and the flow of economic resources measurement focus. Under this basis, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred.

Investments

Investments are stated at cost or amortized cost.

Tennessee State School Bond Authority
Notes to the Financial Statements (Cont.)
June 30, 1997, and June 30, 1996

Amortized Amounts

- a. Bond Issuance Costs. The authority amortizes bond issuance costs using the straight-line method over the life of the bonds. Unamortized bond issuance costs are reported as deferred charges.
- b. Bond Discounts, Premiums, and Deferred Amount on Refundings. The authority amortizes bond discounts and premiums using the straight-line method over the life of the bonds. The deferred amount on refundings is also amortized using the straight-line method over the life of the bonds. Bonds payable are reported net of the applicable unamortized bond discount or premium and the unamortized deferred amount on refundings.
- c. Interest Accretion. The difference between the face amount of College Saver Bonds (capital appreciation bonds) and the public offering price is not treated as bond discount. Capital appreciation bonds are subject to redemption at prices which increase from the initial public offering price to the face amount. The carrying amount of these bonds is adjusted semiannually to reflect the increased liability, with a corresponding charge to interest expense.

NOTE 2. DEPOSITS AND INVESTMENTS

Under the general bond resolution of the Tennessee State School Bond Authority, the funds of the authority can be invested in direct obligations of the United States, or obligations of which the principal and interest are guaranteed by the United States, or certain insured or collateralized accounts. All deposits and investments of the authority meet the requirements of the general bond resolution.

Deposits. The authority's deposits are held in a financial institution which participates in the bank collateral pool administered by the State Treasurer. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure.

At June 30, 1997, the authority had \$844,415 on deposit with the fiscal agent. At June 30, 1996, the authority had \$767,686 on deposit with the fiscal agent.

Tennessee State School Bond Authority
Notes to the Financial Statements (Cont.)
June 30, 1997, and June 30, 1996

The carrying amount of cash on deposit in the State Treasurer's pooled investment fund was \$11,348,546 on June 30, 1997, and \$14,568,340 on June 30, 1996.

Investments. Investments are categorized to indicate the level of custodial risk assumed by the authority at year-end. Category 1 includes investments that are insured or registered or for which the securities are held by the authority or its agent in the authority's name. Category 2 includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the authority's name. Category 3 includes uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent but not in the authority's name.

Authority investments at June 30, 1997, are categorized below (expressed in thousands):

	<u>Category</u>			<u>Carrying</u>	<u>Market</u>
	<u>1</u>	<u>2</u>	<u>3</u>	<u>Amount</u>	<u>Value</u>
U. S. Treasury Notes	\$39,558	\$ -	\$ -	\$39,558	\$39,609
U. S. Treasury Securities-					
State and Local Government					
Series	8,416	-	-	8,416	8,416
Mutual Funds				388	388
	<u>\$47,974</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$48,362</u>	<u>\$48,413</u>

From July 1, 1996, through February 7, 1997, the authority had up to \$14,552 million of U.S. Treasury Notes in category 3 because the securities were purchased and held by the counterparty. Prior to February 7, 1997, up to \$36.7 million in varying amounts was invested in mutual funds.

Authority investments at June 30, 1996, are categorized below (expressed in thousands):

Tennessee State School Bond Authority
Notes to the Financial Statements (Cont.)
June 30, 1997, and June 30, 1996

	Category			Carrying	Market
	<u>1</u>	<u>2</u>	<u>3</u>	<u>Amount</u>	<u>Value</u>
U. S. Treasury Notes	\$ -	\$ -	\$14,552	\$14,552	\$13,670
Mutual Funds				<u>16,893</u>	<u>16,893</u>
	<u>\$ -</u>	<u>\$ -</u>	<u>\$14,552</u>	<u>\$31,445</u>	<u>\$30,563</u>

NOTE 3. LOANS TO HIGHER EDUCATION INSTITUTIONS

The authority and the Board of Trustees of the University of Tennessee and the Tennessee Board of Regents have entered into financing agreements, each originally dated May 1, 1967, and amended and restated as of September 17, 1996, under which the Board of Trustees or the Tennessee Board of Regents, as the case may be, has agreed to construct projects that the authority has agreed to finance. Financing charges payable under the agreement must be sufficient to pay all principal and interest of the notes and bonds of the authority as shall become due.

NOTE 4. RESTRICTED ASSETS

Advance Refunding Investments. This account represents the proceeds of the 1996 Series C and Series D refunding bonds placed in irrevocable trusts with the fiscal agent for the redemption of the outstanding 1989 Current Interest Bonds maturing in 2020 and the 1990 Series B Bonds maturing in 2004-2011.

Debt Service Reserve. The general bond resolution of the authority requires that the principal of each bond issue include an amount equal to the maximum annual debt service requirements and that such amounts be placed in special trust accounts with the trustee; \$39,331,032 is the sum of such amounts provided at June 30, 1997, and \$30,527,981 at June 30, 1996.

NOTE 5. BONDS AND NOTES PAYABLE

Revenue Bonds. The authority issues revenue bonds to finance capital projects for the state's higher education institutions. The bonds, as well as the notes of the authority, are not general obligations of the State of Tennessee. They are secured by a pledge of the revenues from the facilities for which financing has been provided

Tennessee State School Bond Authority
Notes to the Financial Statements (Cont.)
June 30, 1997, and June 30, 1996

through the sale of the authority's bonds and notes and by other revenues and resources available to the authority and to the higher education institutions.

Bonds payable, net of unamortized discount, premium, and deferred amounts at June 30, 1997, and June 30, 1996, are as follows (expressed in thousands):

	<u>June 30, 1997</u>	<u>June 30, 1996</u>
Bonds Payable:		
Tennessee State School Bond Authority Revenue Bonds, 1967 Series A at an interest rate of 4.10% maturing to 2007	\$12,550	\$14,240
Tennessee State School Bond Authority Revenue Refunding Bonds, 1972 Issue at interest rates of 5.25-5.40% maturing to 2005	21,890	25,260
Tennessee State School Bond Authority Revenue Bonds, 1976 Series B at an interest rate of 3.0% maturing to 2011	2,917	3,114
Tennessee State School Bond Authority Revenue Bonds, 1977 Series A at interest rates of 5.40-5.75% maturing to 2006	2,000	2,210
Tennessee State School Bond Authority 1977 Revenue Refunding Bonds at interest rates of 5.40-5.80% maturing to 2011	31,185	33,430
Tennessee State School Bond Authority Revenue Bonds, 1985 Series B at interest rates of 5.90 -7.0% maturing in 2015	27,185	27,935
Tennessee State School Bond Authority Revenue Bonds, 1987 Refunding Series A at an interest rate of 4% maturing in 2012	5,250	61,434
Tennessee State School Bond Authority Revenue Bonds, Series 1989 Current Interest Bonds at an interest rate of 7% maturing in 2020 and 1989		

Tennessee State School Bond Authority
Notes to the Financial Statements (Cont.)
June 30, 1997, and June 30, 1996

College Saver Bonds with yields of of 6.40-6.9% maturing to 2010	28,838	30,430
Tennessee State School Bond Authority Revenue Bonds, 1990 Series A (Taxable) and Series B at interest rates of 6.7-9.0% maturing to 2011	6,455	6,695
Tennessee State School Bond Authority Revenue Bonds, 1992 Series A at interest rates from 5.625-6.25% maturing to 2022	42,475	44,085
Tennessee State School Bond Authority Revenue Bonds, 1996 Series A at interest rates from 5.0-7.0% maturing to 2026	99,780	-
Tennessee State School Bond Authority Revenue Bonds, 1996 Refunding Series B at interest rates from 5.0-6.0% maturing to 2011	51,415	-
Tennessee State School Bond Authority Revenue Bonds, 1996 Refunding Series C at interest rates from 5.375-6.0% maturing to 2020	4,045	-
Tennessee State School Bond Authority Revenue Bonds, 1996 Refunding Series D at interest rates from 5.0-5.5% maturing to 2011	<u>4,400</u>	<u>-</u>
Total Par Amount of Bonds Payable	<u>340,385</u>	<u>248,833</u>
Plus Unamortized Premium/Less Unamortized Discount	<u>(813)</u>	<u>(2,192)</u>
Bonds Payable Net of Unamortized Premium/Discount	<u>339,572</u>	<u>246,641</u>
Less: Deferred Amount on Refundings	<u>(2,339)</u>	<u>-</u>
Net Bonds Payable	<u><u>\$337,233</u></u>	<u><u>\$246,641</u></u>

Tennessee State School Bond Authority
Notes to the Financial Statements (Cont.)
June 30, 1997, and June 30, 1996

Under the terms of the \$27.185 million 1985 Series B Tax-Exempt Exchangeable Securities, on semiannual payment dates, each holder of the 7% securities may exercise a one-time election to convert to a variable interest rate, not to exceed 10%, as established by an independent municipal securities evaluation service pursuant to a prescribed formula. At June 30, 1997, \$17.47 million of the bonds were held at an interest rate of 7.0%, and \$9.715 million were held at a variable interest rate.

Debt service requirements to maturity of the revenue bonds payable at June 30, 1997, are as follows:

For the Year(s) <u>Ending June 30</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
1998	\$ 18,978	\$ 19,188	\$ 38,166
1999	19,739	18,417	38,156
2000	19,383	17,563	36,946
2001	17,691	16,460	34,151
2002	18,382	15,648	34,030
2003-2026	<u>235,595</u>	<u>138,984</u>	<u>374,579</u>
Total	<u>\$329,768</u>	<u>\$226,260</u>	<u>\$556,028</u>

The above principal for revenue bonds is \$7.465 million less than that presented on the accompanying financial statements. Of this amount, \$9.804 million represents accretion to date of interest on capital appreciation bonds in the years preceding the principal payment on the bonds and has been reported as bond principal in the financial statements. It has been reported above as interest in the years in which the bonds mature (1998-2010). The \$7.465 million also includes \$2.339 million which is a deduction from bonds payable for the deferred amount on refundings and is not reflected in the presentation above.

The authority issued \$102,710,000 of revenue bonds (1996 Series A) which, along with an equity contribution of \$2,869,712, provided resources to purchase securities that were placed in an irrevocable trust to redeem \$73,970,288 of its variable rate notes, pay one month's interest on the notes, fund \$20,873,068 of new projects, fund the debt service reserve fund and pay the costs of issuance of the bonds. This reduced the authority's variable rate debt as a percentage of total debt from 30.39% to 11%.

Tennessee State School Bond Authority
Notes to the Financial Statements (Cont.)
June 30, 1997, and June 30, 1996

Current and Crossover Refundings. The authority issued \$55,300,000 of revenue bonds (1996 Refunding Series B) for a current refunding which, along with an equity contribution of \$3,163,739 provided resources to purchase securities that were placed in an irrevocable trust to redeem \$56,184,000 of the 1987 Series A Bonds on November 1, 1996, and pay the costs of issuance of the bonds. The refunding resulted in a difference between the reacquisition price and the net carrying amount of the old debt of \$2.47 million. This difference, reported in the accompanying financial statements as a deduction from bonds payable, is being charged to operations through the year 2011 using the straight-line method. The authority completed the refunding to reduce its total debt service payments over the next 14 years by \$7.3 million and to obtain an economic gain (difference between the present values of the old and new debt service payments) of \$4.4 million.

The authority issued \$4,045,000 of revenue bonds (1996 Refunding Series C) as a crossover refunding which provided resources to purchase securities that were placed in an irrevocable trust to pay interest on the 1996 Refunding Series C Bonds until May 1, 1999, and on May 1, 1999, to redeem \$3,880,000 of the 1989 Current Interest Bonds maturing on May 1, 2020. Proceeds of the refunding are invested in United States Treasury Securities - State and Local Government Series maturing on certain dates and in various amounts through May 1, 1999. This issue represents an advance refunding investment through May 1, 1999, during which time both issues will be reported on the authority's financial statements. During the period prior to the defeasance, the higher education institutions will continue to provide funds necessary to meet the debt service on the refunded issue. Interest earnings from the investment will be used to satisfy the debt requirements of the refunding issue to the crossover date. On the crossover date, the authority will reduce its total debt service payment over a 20-year period by \$560,718 and obtain an economic gain of \$332,789.

The authority issued \$4,400,000 of revenue bonds (1996 Refunding Series D) as a crossover refunding which provided resources to purchase securities that were placed in an irrevocable trust to pay interest on the 1996 Refunding Series D Bonds until May 1, 2000, and on May 1, 2000, to redeem \$4,310,000 of the 1990 Series B Bonds maturing 2004-2011. Proceeds of the refunding are invested in United States Treasury Securities - State and Local Government Series maturing on certain dates and in various amounts through May 1, 2000. This issue represents an advance refunding investment through May 1, 2000, during which time both issues will be reported on the authority's financial statements. During the period prior to the defeasance, the higher education institutions will continue to provide funds necessary to meet the debt service on the refunded issue. Interest earnings from the investment

Tennessee State School Bond Authority
Notes to the Financial Statements (Cont.)
June 30, 1997, and June 30, 1996

will be used to satisfy the debt requirements of the refunding issue to the crossover date. On the crossover date, the authority will reduce its total debt service payment over an 11-year period of \$413,851 and obtain an economic gain of \$269,069.

Notes. Notes payable consist of monies drawn from the Bond Anticipation Notes (BANs) Program established February 24, 1993, with Prudential Securities, Incorporated, as the underwriter and remarketing agent, to fund interim and short-term financing projects being constructed or purchased by various institutions of higher education throughout the state. Under the BAN's Program the notes will mature on March 1, 1998, and may bear interest at a variable rate (daily, weekly, monthly, quarterly, semiannually, or annually) or a fixed rate (long-term) determined by the remarketing agent for periods selected by the authority. Currently, interest is determined on a weekly basis and payable monthly. The notes are subject to purchase by the remarketing agent on the demand of the holder on any business day pursuant to the conditions established in the Note Resolution, as described in the Official Statement relating to the notes. The remarketing agent is to use its best efforts to sell the notes to another holder. If the agent is unable to resell any notes that are "put," the standby note purchaser is required, subject to certain conditions, to purchase the notes. Swiss Bank Corporation, New York Branch, served as the standby note purchaser through June 25, 1996.

The Standby Note Purchase Agreement with Swiss Bank Corporation provided that the authority pay a commitment fee per \$1,000 of the principal commitment and interest commitment totaling \$75,961,644 payable quarterly in arrears. From July 1, 1995, through February 24, 1996, the fee was 15 basis points per annum; from February 25 through June 25, 1996, the fee was 13 basis points per annum.

Effective June 26, 1996, the authority contracted with Union Bank of Switzerland to serve as the standby note purchaser under the BAN's Program through June 25, 1997. The total available commitment under this agreement was \$106,173,699. The commitment fee is payable quarterly in arrears, at a rate of 6 basis points for the utilized and 5 basis points for the unutilized portion of the commitment based on a 360-day year. If the bank purchases bond anticipation notes, there is a drawing fee of \$500. The interest rate on the notes while held by the bank is the higher of the bank's prime rate or Fed Funds rate plus 1% per annum. There was no acceptance fee, but the authority paid certain expenses of the bank in connection with the delivery of the agreement. On May 27, 1997, Union Bank of Switzerland extended the Standby Note Purchase Agreement to March 1, 1998, the expiration date of the BAN's Program. The commitment was reduced to \$64,523,274 to provide liquidity for the \$63,810,000 remaining principal authorization under the BAN's Program and

Tennessee State School Bond Authority
Notes to the Financial Statements (Cont.)
June 30, 1997, and June 30, 1996

interest for 34 days at 12% thereon. All fees remained the same. From time to time, a portion of the notes will be redeemed with the proceeds of the sale of bonds at the end of the construction period or from periodic payments from the institutions for short-lived assets.

The average interest rate on the notes for the year ended June 30, 1997, was 3.43% and for the year ended June 30, 1996, was 3.52%.

Notes payable at June 30, 1997, and June 30, 1996, are as follows (expressed in thousands):

	<u>June 30, 1997</u>	<u>June 30, 1996</u>
Notes, at the weekly market rate, dated March 1, 1993, due March 1, 1998	<u>\$42,095</u>	<u>\$104,585</u>

NOTE 6. PRIOR PERIOD RESTATEMENT

The financial statements for the year ended June 30, 1996, have been restated to reflect the accreted value of the 1989 College Saver Bonds. As a result, revenue bonds payable and principal due from higher education institutions have been increased by \$9.295 million and bond interest expense and revenue from higher education institutions have been increased by \$754,211.

NOTE 7. SUBSEQUENT EVENTS

The authority has incurred a contingent arbitrage liability of \$27,237.25.

In July 1997, the authority issued \$21,715,000 of additional notes under the BAN's Program established February 24, 1993. On September 1, 1997, the authority redeemed \$2.475 million of the notes. On December 1, 1997, the remaining \$61.3 million of the notes were redeemed with proceeds of the commercial paper program.

In November 1997, the authority initiated the new short-term note program to provide initial funding for various construction projects and funding of short-lived assets. The authority entered into Second Program Financing Agreements with the Board of Trustees of the University of Tennessee and the Tennessee Board of

Tennessee State School Bond Authority
Notes to the Financial Statements (Cont.)
June 30, 1997, and June 30, 1996

Regents dated November 1, 1997, which secure the commercial paper. The authority issued \$4.55 million of taxable and \$65.8 million of tax-exempt commercial paper. J. P. Morgan Securities, Inc. serves as the commercial paper dealer and an Advance Agreement is provided by the Union Bank of Switzerland. Under the program, notes may be issued for a period not to exceed 270 days and will bear interest based upon the specified term of the note. At the maturity of each note, the dealer is to use its best efforts to sell new note(s) to another holder. If new note(s) cannot be sold, the authority is able to sell, subject to certain conditions, a variable rate note to the bank pursuant to the Advance Agreement in an amount sufficient to pay the maturing principal of the note. The bank note will bear interest at a rate which is the greater of (1) the Fed Funds rate plus 100 basis points or (2) the bank's prime rate based on a 360-day year. This interest rate will increase periodically over the life of the bank note. The bank note will mature upon the earlier of (1) the successful sale of a note or (2) November 17, 2000.

The Advance Agreement provides for an aggregate available commitment totaling \$152,250,000 at an annual fee of .085% on the average daily aggregate principal amount of commercial paper notes outstanding plus an interest component thereon equal to 12% of such average daily aggregate principal amount and a fee of .08% on the difference of the aggregate available commitment and the amount calculated on the outstanding commercial paper. Fees are due quarterly in arrears. The Agreement expires November 17, 2000, unless extended.